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Introduction

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What makes not-for-profit organizations different from their for-profit alternatives? Nonprofit organizations have tax privileges: Donations to them are tax deductible, and nonprofit organizations are themselves free from many tax burdens. These tax advantages are at the heart of nonprofit status, and the nonprofit sector owes its strength, in part, to tax deductibility. A second difference between nonprofits and for-profits is the nondistribution constraint. Nonprofit organizations cannot disburse profits to owners or employees. This constraint affects the nature of nonprofits in important ways, and may enable nonprofits to commit not to cheat customers or workers (see Hansmann 1996; Weisbrod 1988; Glaeser and Shleifer 2001).

As striking as these differences between nonprofits and for-profits may be, a third difference is as important in explaining the behavior of nonprofit organizations: Nonprofit organizations do not have owners. The people who fund nonprofits, through donations, do not explicitly gain control rights over the firm. Nonprofit organizations do have boards, which do have control rights, and these boards are often partially composed of donors and their representatives.

But nonprofit boards are self-perpetuating and not accountable to share-

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holders. They are rarely subject to elections or never to takeovers.[1] Board members cannot sell or transfer their control rights, so they do not own an asset the value of which is tied to the organization's success. There is certainly no legal rule requiring boards to act as custodians of the interests of past investors or donors. The law constrains itself to generally vaguely worded requirements about the nonprofit's mission. Moreover, given the murky missions of many nonprofits, their managers are inherently harder to incentivize. A for-profit manager's income can be tied to the stock price of his firm, but no similar benchmarks exist for most nonprofits. Indeed, many forms of incentive pay are illegal for nonprofit organizations.

The result of these factors is that the managers of nonprofit organizations—the chief executive officer (CEO) and the board—have an almost unmatched degree of autonomy. Donors often recognize that they have little influence on the institutions that they endow and they make their donations accepting that the only effects of their gifts will be to increase the budget of the recipient nonprofit. Furthermore, while nonprofit managers do not inherently maximize the objectives of either investors/donors or society as a whole, it is less clear what these managers do maximize or what ultimately drives the decisions of nonprofit organizations. This book represents an attempt to shed some new light on the objectives that govern nonprofit organizations.

Indeed, given the weak nature of corporate control in nonprofits, the most surprising thing to me about these organizations is that they function as well as they do. Widespread looting of endowments is almost unheard of. Nonprofit universities and hospitals generally do a credible job of educating students and curing the sick. While I will argue that workers do tend to subvert the mission of nonprofits, I also think that this subversion is ultimately modest and in some cases creates its own social benefits. Indeed, I suspect that, as the model suggests, competition in the market for customers and donors ultimately disciplines nonprofit organizations in a way that keeps them reasonably honest. If this suspicion is correct then it suggests that understanding the ability of competition to solve agency problems deserves much more research.

This introductory essay begins with a simple model of the choices made by nonprofit organizations. I consider a model with four types of actors: a manager (meant to represent the CEO and the board), workers, donors, and customers. Each of these actors has different preferences about the nature of the organization's product. The model focuses on whose preferences come to dominate the firm's decision making. Does the firm ultimately hew toward the preferences of donors, customers, workers, or management?

1. There are certainly minor exceptions to this claim. Many churches and synagogues have boards elected by parishioners. Alumni groups are frequently entitled to elect some members of university boards.

I assume that in the nonprofit organization, the manager decides on the nature of production and maximizes preferences over both the amount of output and its attributes. The level of donations, workers' salaries, and the sale price are all functions of the output attributes. Furthermore, workers are assumed to directly influence, lobby, or punish the manager if he or she deviates from their preferences. In some cases (think of the student riots in the 1960s), customers are also able to cause pain to management as well.

The most central result of this model is that worker preferences tend to be more important in nonprofits than in for-profit firms. In a profit-maximizing firm, worker preferences only matter to the extent that workers are willing to accept lower salaries. Even if workers are able to lobby managers, shareholders should be able to create incentives to undo the influence of elite workers. Of course, in reality, for-profit firms are often subverted by workers, especially top management. But the weak incentives in nonprofit organizations means that workers will have more influence within nonprofits. Indeed, as Glaeser and Shleifer (2001) argue, the ability of workers to protect themselves from ex post appropriation in nonprofits may be a major reason for the success of nonprofit organizations.[2]

Within and across nonprofit organizations, there will be a wide degree of variation in the extent to which workers are able to influence outcomes. Across workers, the ability to impact decision making depends on the amount of direct contact with the manager, the extent to which the CEO comes from a specific class of workers (e.g., professors, doctors), and the extent to which individual workers are able to punish or reward the CEO, especially through the press. As such, the model predicts that elite workers who interact with the CEO will have influence. Lower-level workers will not.

Across nonprofit organizations, the degree of worker control will rise with the wealth of the firm. Firms that are wealthy can afford to cater to their own interests rather than focusing on courting new donors or on making money through customers. Indeed, the model suggests that nonprofits will have a life cycle where they are originally controlled by initial donors who select the board and continue to provide financing for the firm. However, over time, as the initial donors die off and as the firm becomes richer, the preferences of workers will tend to dominate the preferences of donors. If there is a shock to the income level of the firm, caused by an exogenous fall in price or increase in costs of production, then nonprofit organizations will become more commercial (i.e., cater more to the interests of consumers), and the preferences of management and workers will become less important.

2. Indeed, one aspect of the model in that paper is that nonprofit managers care less about profits than about embarrassment. This preference comes ultimately from the weak governance of nonprofits.

The model implies that the Pauly and Redisch (1973) view of hospitals as doctors' cooperatives is likely to be applied to many areas of nonprofits.[3] Instead, the generally weak governance of nonprofit organizations means that if the organizations get wealthier over time, they will almost invariably become oriented toward the interests of their elite workers. Indeed, in many of the most important nonprofit sectors, including religion, art museums, and academia, the growth of the industry was closely linked to at least a partial capture of the wealthier organizations by their workers. Certainly, as we have known since Berle and Means, for-profit corporations also face this problem. But the mechanisms that have made for-profit firms at least somewhat accountable to shareholders are ultimately much weaker in nonprofit organizations, and as such elite workers in nonprofit become much more dominant.[4]

Of course, there are many factors that limit the extent to which nonprofits deviate from their social goals. Boards do include representatives of at least relatively recent donors, and management is certainly motivated to attracting new donors. The nonprofits that actually sell to the public generally must pay some attention to consumer demand, especially if their prices are close to market rates.[5] Legal restrictions are also important. Nonprofits that pay their workers too much or that diverge too far from their mission statement may be subject to legal challenges. Finally, worker preferences are often themselves altruistic and often internalize the stated goals of the organization. Nonprofits are not organizations that selfishly maximize the income of their workers, but they are organizations where the preferences of elite workers come to have a very large and perhaps undue amount of influence.

Board control is strongest in areas that are clearly observable, such as the size of salaries and decisions about construction. This will tend to limit the extent to which workers are able to lobby for higher salaries and will induce workers to focus on less measurable amenities. Indeed, if boards are able to force salaries to be competitive (i.e., to make sure that there are not huge queues for jobs in the nonprofit), then the degree of worker influence over firm production can explain the well-known fact that salaries in nonprofits are generally lower. If the salaries of nonprofit workers are limited by competition, then salaries in nonprofits will be pushed down to reflect workers' greater ability to influence the organization. Even if full compensation doesn't occur, and nonprofit workers end up with rents, competition

3. McCormick and Meiners (1988) discuss the property rights that professors have over universities and essentially point to universities as being close to faculty-run institutions.

4. One view is that since the mid-1970s, a number of institutions including takeovers and incentive pay have served to reorient for-profit managers toward shareholder value. No comparable changes have occurred for nonprofits.

5. In many cases, nonprofit firms appear to price at far below market rates. This both serves a charitable function and also gives them the freedom to control the product without worrying about having to cater excessively to consumer preferences.

for jobs generally will mean that greater control over production is accompanied by lower wages.

Another implication of the model is that the composition of donors to nonprofit organizations will differ with the endowment level of the organization. Donors who are interested in impacting firm behavior will go to small nonprofits that they can control. The donors who give to large nonprofits cannot expect to affect the organization very much, except in cases where they can write a legally or reputationally enforceable contract. As such, donors to large nonprofits will either have preferences that are well matched with the preferences of elite workers or they will be driven by a desire to signal generosity and wealth. Donors to smaller nonprofits generally will be driven by a desire to impact the organization's behavior. Donors to wealthy nonprofits will also tend to have tastes that are more in line with the tastes of the workers in those nonprofits.

A third set of implications concerns the determinants of commercialism in nonprofits. One of the major topics in nonprofit research has been the convergence of nonprofit and for-profit behavior, especially in the medical sector. The model suggests that this type of convergence occurs in two different ways. First, negative shocks to the earnings of nonprofits will cause them to behave in a way that is more calculated to appeal to consumer tastes. Certainly, some of the commercialism of hospitals has occurred because of declining rents in that industry. Second, nonprofits will always be attuned to money-making opportunities, and a rise in the returns to commercialism will also make nonprofits more commercial. In Duggan (2000), nonprofit organizations seem perfectly able to take advantage of a clear money-making opportunity. This helps us to understand Barro's chapter in this volume showing that advertising rose most among the rich, university hospitals, not among the cash-strapped hospitals. He explains this by arguing that the returns to this form of commercial activity have risen most for nonprofits with the highest quality level.

Finally, the general freedom of nonprofit managers will tend to mean that there is much more variance over time and across companies in the structure and methods of nonprofits (relative to for-profits). If there is a profit-maximizing way to produce, then our models predict that profit maximizing should generally follow that strategy. However, nonprofits are much more likely to follow whatever quirky ideas dominate the opinions of their CEO. This variance will be limited if workers as a group are homogeneous across nonprofits and if CEO behavior tends to cater to the elite workers. As such, the model predicts that managerial style, which Bertrand and Schoar (2002) find to be important in for-profit firms, should be even more important in nonprofit organizations.

After presenting the model, I discuss donor-worker-customer conflicts in four key nonprofit industries: academia (particularly the better-endowed universities), hospitals, art museums, and the Catholic Church. I

argue that all four industries support the basic point of the model: Weak incentives mean that workers come to greatly influence the practices of nonprofits. However, competition still acts to check massive rent extraction and to keep nonprofits oriented toward customers. Universities generally were originally dominated by their donors and the clergy. From 1900 to 1960 academics and higher-level administrators came to dominate these institutions. In 1890, donors and customers were the dominant figures in the life of the university. Professors were freely dismissed if their views differed from those of trustees, even on religious matters that were unrelated to their teaching. One hundred years later, academics and elite administrators exercise an incomparably larger degree of control over the nature of the university. Universities still cater to customers, and competition has certainly limited the growth of faculty salaries, but the rise of the research university is intimately related to professors gaining influence over the management of the academy.

Hospitals were also initially dominated by donors who supported them as charitable institutions for the poor. Initially, doctors often had little control over their management. Again, as they grew richer, they became much more oriented toward the interests and objectives of elite doctors. Hospitals for the indigent became elite research hospitals focused on the interests of their most impressive doctors. Only in the past thirty years have recent changes in the industry caused a re-orientation of these hospitals (see Weisbrod 1998). As the model predicts, this reorientation appears to be the result of a substantial decline in the amount of available rents.

Art museums likewise have seen a transformation from donor-controlled institutions to institutions where curators wield more power, but the transition has been more modest. Donors are still quite dominant in many institutions. This relatively large amount of continuing donor control occurs because art museums generally have limited free cash (their endowments are primarily in nontransferable works of art) and they depend on donors for new purchases. Of course, this is itself endogenous—donors know better than to give museums unrestricted cash. Art museums have generally been less effective in funding themselves with customers, but perhaps the financial success of blockbuster exhibitions will end up freeing museum management from donors and giving them more autonomy.

My final example of the transformation from donor to worker control is the Catholic Church. One thousand years ago, lay leaders—the founders of the church—exercised a phenomenal amount of control over the institution: They chose bishops, they determined church policy, and even the pope was ultimately beholden to the secular authorities who supported him. Over the last three hundred years, the wealth of the church grew significantly and with it the degree of priestly power. In recent years as well, the rise of various churches in the United States and elsewhere has been accompanied by church workers freeing themselves from lay control.

Finally, I end the paper by reviewing the seven subsequent chapters in this volume. These papers relate to various aspects of nonprofit behavior. Two of these are general: Fisman and Hubbard examine endowments, and Malani, Philipson, and David review the empirical literature on what nonprofits maximize. Three are focused on the medical sector: Hansmann, Kessler, and McClellan show that nonprofits are slower to respond to negative demand shocks than their for-profit competitors, Erus and Weisbrod look at bonuses in nonprofits, and Barro examines hospital advertising. Goetzman and Oster examine the behavior of art museums, and Nelson and Zeckhauser examine donor-church relations in Renaissance Florence.

The Model

I consider a nonprofit an organization that produces a good (e.g., health care, education, etc.) that is characterized by number of units sold, denoted N, and a production attribute, denoted X. This X attribute is meant to capture things like the research orientation of medical care in hospitals, the spending decisions of universities, the degree of openness of art museums, or the style in which ministers preach. Different values of X will impact the utility of managers, workers, donors, and customers. X is a continuous scalar variable that lies between –1 and 1. In a more realistic model, X would be a rich vector of characteristics.

This production attribute, X, will have different interpretations in different settings. For example, in a university, the value of X might correspond to the extent to which the university focuses on research or teaching. In hospitals, the value of X might capture the amount of attention paid to reputation-making rare diseases versus the amount of attention paid to more common ailments. In churches, X might capture the degree to which sermons focus on what the clerics believe relative to what the congregation wants to hear.

The good is sold for a price $P(|X - X_C|)$ where $P(.)$ is a strictly decreasing function and $|X - X_C|$ is the absolute value operator. In the case of some nonprofits P may be fixed at zero. In the case of for-profits, P is unlikely to be zero. The value of X_C represents the ideal nature of the good to consumers. Thus, in a university context, customer willingness to pay for classes might depend on the extent to which those classes are entertaining or cater toward productivity in the workplace.

The organization produces using a manager, exactly one unit of labor, and a flexible amount of capital. The cost of capital is $K(N)$, where $K(.)$ is an increasing, weakly convex function (in most cases, I will assume that $K[N]$ is linear). The wage rate of labor is denoted W, so that total costs of production are $W + K(N)$. The utility of workers' utility equals their wage, W, plus BX. I assume that X is ordered so that workers always prefer higher

values of X. The parameter B captures the degree to which workers care about this aspect of production.

The reservation utility of workers equals $\underline{W}$. One key issue is the degree to which wages are set by market forces and the degree to which wages will respond to the level of X. Given that I am assuming a fair amount of divergence from profit-maximizing behavior, in principle, it might be possible for workers to capture the organization and pay themselves extremely high wages. In line with the experience of most nonprofit organizations, I assume that this does not occur and that wages must be at least somewhat responsive to the degree of competition for the jobs. In essence, I am assuming that if the queues for nonprofit jobs get too long, someone in management notices and cuts salaries, at least a little. This is the first place in the model where I implicitly assume that competition (in this case labor market competition) serves to limit rent appropriation in nonprofits.

However, I do allow that workers in nonprofits will be able to receive rents. The form this will take is that, in some nonprofits, workers' perquisites will rise and wages will not fall one-for-one. In the language of the model, wages may not respond fully to changes in the level of X. To capture the range of possibilities, we assume that wages, W, equal $\underline{W} - \sigma BX$, where σ can range from zero to 1. Low values of σ imply that workers are actually able to appropriate rents from the job if they influence the character of the organization's production. High values of σ imply that workers' utility levels are determined entirely by their outside opportunities. Lower values of σ imply that workers are able to keep more of the rents that their lobbying activities generate.

Recognizing that for-profit firms often face their own incentive problems and fail to maximize profits, I still begin with the benchmark case of a purely profit-maximizing firm. Such a firm will choose X and N to maximize $P(|X - X_C|)N - K(N) - (\underline{W} - \sigma BX)$, which implies that the firm will choose output so that $P(|X - X_C|) = K'(N)$, and X so that $P'(|X - X_C|)N + \sigma B = 0$. This implies that profit-maximizing firms will choose a level of X that is greater than X_C (to reduce their wage bill), and, generally, the value of X will rise with σ and B. Profit-maximizing firms will internalize the preferences of their workers more as workers care more about the attribute and as their wages respond more to workplace amenities.

In the case of nonprofit organizations, no simple profit-maximizing rule can be assumed. Instead, I assume that the choices of X and N are made by a manager with his or her own preferences over the value of X. In the nonprofit context, this manager is meant to represent a combination of the CEO and the board. I assume that the direct utility for the manager from production equals $f(N) - g|X - X_M|$. Thus, the manager receives utility both from the scale of production and from the extent to which the good aligns well with his own preferences. The scale maximization assumption is somewhat arbitrary, but given the lack of evidence about the objectives

of nonprofit boards, it seems as good an assumption as any. The value of X_M reflects the manager's preferences about the product, and I will assume that this lies between zero and 1.

The nonprofit must earn exactly zero profits. Positive profits would violate the non-distribution constraint. Negative profits would lead to bankruptcy. The organization's revenues come from sales, the endowment (equal to E), and new donations. The supply of endowment is exogenous, but the flow of new donations is determined by donors who also respond to the value of X. In the case of a new nonprofit, the donors might themselves be able to choose the board and select the value of X. However, for more mature organizations, donors rarely exercise strong control and as such are probably best seen as "price" or X takers who accept the characteristics of the organization as given and then allocate funds more to nonprofits who fit their preferences. To highlight the potential conflict between donors and workers, I assume that donors' preferences are opposed to those of workers and that the donor would ideally like X to equal zero. The level of donations will be a function $D - d|X|$.

The value of d reflects the degree to which donations respond to the organization's product. Higher levels of d should be interpreted as reflecting a more competitive market for donations. If this market is more competitive and if the organizations stray from providing the goods that donors want, donations will tumble. If the organization has a monopoly on its donors, then the level of donations will be invariant with respect to X (i.e., d will be small).

A nonprofit organization faces a break-even constraint that implies that total profits, or $P(|X - X_C|)N + D - d|X| + E - (\underline{W} - \sigma BX) - K(N)$, must equal zero. Competition in three markets impacts profitability: the eventual product market, the market for donations, and the labor market. All three of these markets will act to discipline nonprofits and keep them from catering to the whims of top management. Some nonprofits, for example, large foundations that do not look for new donations and that give money away, only compete in one market. As a result, their profits will only be influenced by competition for labor, not by competition in either of the other two markets.

Workers' preferences are internalized by management in two ways. First, just like for-profit firms, nonprofit organizations will respond to the impact that catering to employees will have on wages. Second, I assume that workers can impose a cost of C times $(1 - X)$ on management. The level of cost is increasing in the distance between the actual attribute of the good and the workers' desired nature of the good. Examples of this cost would include publicly embarrassing the CEO by talking negatively about him to newspapers or just impeding his progress through obstructionist tactics. This is meant to reflect the power that workers generally have over the quality of life of their bosses. In principle, workers in for-profit firms can also

influence their CEOs, but in the case of for-profit firms, shareholders may be able to cause the CEO to care more about profits than about elite worker influence.

Because managers are workers who are selected by boards, I will assume that the preferences of managers lie between the preferences of workers and donors, i.e., X_M lies between zero and 1. I consider a nonprofit organization where the manager solely maximizes his own utility subject to the constraint that total net revenues are nonnegative. The manager then maximizes $f(N) - g|X - X_M| - C(1 - X)$ over N and X subject to this constraint. The first-order condition for the level of N yields $P(|X - X_C|) + f'(N)/\lambda = K'(N)$, where λ is the multiplier on the balanced budget constraint.

If we let X_N refer to the value of X chosen by the nonprofit organization, then the following proposition holds:

Proposition 1. *The level of production will be greater in the nonprofit organization than in the for-profit firm if and only if* $P(0) < P(|X_N - X_C|) + f'(N)/\lambda$.

As long as $P(0) < P(|X - X_C|) + f'(N)/\lambda$, then this first-order condition gives us the familiar result (shown in Malani, Philipson, and David, chapter six in this volume) that nonprofits will produce more than for-profits because they have a direct taste for production (the $f'(N)$ term in this equation). This proposition also suggests that nonprofits will be slower to shut down hospitals in the face of declining profitability, as found by Hansmann, Kessler, and McClellan (chap. 1 in this volume).

However, if $P(0) > P(|X - X_C|) + f'(N)/\lambda$, then for-profit firms produce at a larger scale than nonprofit organizations. The intuition of this result is that for-profits end up making goods that appeal more to consumers. As such, the price that for-profit firms receive will be higher, and the marginal benefit to them of producing is also higher than the marginal benefit of producing to the nonprofit organization. One example of this phenomenon might be nonprofits that produce very elite products, such as public radio and television, which have less market appeal than their for-profit alternatives.

To focus on the determinants of X, I now assume that $K(N) = KN$ and that $K > P(0)$. This assumption, combined with the zero profit assumption, means that nonprofits produce in areas where for-profits would lose money and shut down. If $X > 0$, then the level of N for the nonprofit firm will equal $(E + D - d|X| - W)/(K - P[|X - X_C|])$. Values of X that please consumers will increase scale by raising the overall revenues. Values of X that appeal to donors will increase scale by raising the level of donations. Thus, the managers will have to decide on a value of X, taking into account that they can either cater to their own wishes (or the wishes of workers) and produce at a smaller scale, or they can cater to the wishes of donors and customers and produce at a larger scale.

The manager chooses N and X to maximize $f(N) - g|X - X_M| - C(1 - X)$ subject to the constraint that N equals $(E + D - \underline{W} - d|X| + \sigma BX)/(K - P[|X - X_C|])$, which yields the first-order condition

$$(1) \quad P'(|X - X_C|)N + \sigma B = d \cdot I(X > 0) - [C - g \cdot I(X > X_M)] \frac{(K - P)}{f'(N)},$$

where $I(X > k)$ is an indicator function that takes on a value of 1 if $X > k$ and –1 otherwise. I assume that d is greater than σB to avoid a corner solution where workers' preferences completely dominate the organization's choices.

Comparing this first-order condition with the first-order condition for the profit-maximizing firm (i.e., $P'[|X - X_C|]N + \sigma B = 0$) shows that nonprofits will not produce the same products as for-profit firms. Their output will be directed toward the interests of donors and workers in a way that is different from for-profits. If d is small, and $X_M > X_C$, then nonprofits will cater to worker and manager taste more than for-profits will. As such, all nonprofits, not just Pauly and Redisch's (1973) hospitals, will resemble workers' cooperatives.

The forces that mitigate this effect will be the preferences of customers and donors. Again the degree of competition in the product or donation markets is crucial. If the level of donations is quite susceptible to the attributes of the product, then the organization will end up catering to donors. If the product market is highly competitive, which would be represented by a higher value of $P'(.)$, then the organization will end up catering to customers. Worker capture is a real possibility in nonprofits, but this capture will be tempered by competition.

Proposition 2. *If $P'(|X - X_C|) = P$ then $X > 0$ and if $d > \sigma B$, then the value of X is rising with σ, B, C, D, E, and falling with d and $\underline{W}$. The value of X is falling with K and rising with P if and only if $f'(N) > -Nf''(N)$.*

The assumption is that $P'(|X - X_C|) = P$ eliminates the role of competition for consumers at this stage. I will return to this form of competition later in the model. Here, this assumption implies that X will be positive, since a negative value of X would only hurt the manager through direct utility loss, higher wages, punishment from workers, and lost donations.

These comparative statics are the heart of the model. The manager faces a tradeoff between accommodating the donors and accommodating the workforce. The manager's interest in accommodating the workforce is naturally driven by the extent to which the workers can cause pain to the manager and by the extent to which their wages can be reduced by catering to their desires. Thus, if the manager is particularly dependent on the workers or if the workers have the ability to embarrass the manager, then the manager will be likely to accommodate their desires, not the desires of the donors.

In profit-maximizing firms, worker preferences only change firm behavior if they impact wages. In nonprofits without incentives, worker preferences will matter because of the ability of workers to influence or punish management. As such, nonprofits and profit-maximizing firms are predicted to cater to different workers. Profit-maximizing firms are predicted to change working conditions if those changes can reduce the wage bill. Nonprofits are predicted to change working conditions to cater to those workers who are able to directly influence or punish the CEO and board.

A more complicated model would allow different groups to have different abilities or willingnesses to engage in different forms of lobbying. In that case, we would expect those workers with a particular ability to influence management to receive the biggest amenities. The workers that are physically closest to the CEO or that have the best ability to use the press to embarrass the CEO are likely to acquire the most rents.

If the division of labor increases in the largest nonprofits, then CEOs will mainly interact with other administrators. In smaller nonprofits, CEOs will have more direct contact with the actual workers in the organization. As such, the CEOs in the largest nonprofits may tend to be more oriented toward the desires of administrators while the CEOs in smaller (but still wealthy) nonprofits may be more oriented toward other elite workers. This might explain why many observers argue that the University of Chicago is more faculty oriented, while larger universities, such as Harvard or Stanford, might be more oriented toward the desires of top administrators.

Given that CEOs will cater to their friends, forward-looking nonprofit boards should choose CEOs from different interest groups over time if they are interested in maintaining balance in the orientation of the firm. Perhaps it might make sense to alternate between an administrator and an academic in choosing university presidents. Given the ability to direct for-profit CEOs using incentives, there is less reason to choose a for-profit CEO by cycling among different interest groups.[6]

The tendency to favor donors decreases with the innate wealth of the organization and rises with competition in the market for donations. If donations are forthcoming regardless of whether the donors are satisfied or if the organization has a large endowment, then the marginal benefits of satisfying the donor are less. This follows from the concavity of $f(.)$. Higher levels of innate income mean that the organization is already producing a significant amount of output and there is little need for more production. This will suggest that in early stages of the organization, when the endowment is low and the organization is really dependent on new donations,

6. Of course, different for-profit CEO styles may be appropriate at different times (see Bertrand and Schoar 2002), but in the case of an incentivized CEO there is less reason to cycle in order to take care of all of the interest groups.

donor preferences will be followed. However, as the wealth of the organization increases over time, the manager will find the pressure of his workforce more important than the desires of donors.

An innately lower value of $\underline{W}$ will act as an income shock, so organizations that have an innately cheaper workforce will be free not to accommodate donors. An example of an organization with access to particularly cheap labor might be the church. In a sense, faith-subsidized labor acts just like an endowment for religious organizations. Firms that hire workers at market wages will have to pay more attention to the needs of donors, and firms that have access to below market wage workers will not. Volunteer labor frees organizations from attending to donors' wishes.

Greater competition in the donation market, d, induces the organization to follow the wishes of donors more. Alternatively, d might be low because donors are particularly motivated by a desire for prestige, as the Goetzman and Oster chapter in this volume emphasizes. Some nonprofits, because of their permanence and visibility, might provide an ideal way to signal wealth and altruism. If donors are presumably interested in having their names clearly attached to permanent things, such as buildings, but otherwise they do not really care about the internal functioning of the nonprofit (as long as it survives), then d will be low.

Even if d is high, nonprofits are likely to follow the desires of prospective donors, not past donors. The lack of legal controls means that unless the tastes of the new donors (or the CEO) line up well with the tastes of the "old" donors, old donors will have little sway. In practice, older donors tend to have influence on nonprofits in two ways: explicit legal arrangements that bind nonprofits and representation on the board.

One example of explicit legal restrictions is the actual mission statement of the nonprofit. In principle, if management strays too far from this mission statement, it can open itself up to legal action. A recent example includes the legal challenges that were considered a few years ago against the Lincoln Land Institute. The Lincoln Land Institute was set up by a philanthropist follower of Henry George. As national interest in the ideas of Henry George has waned, recent management has certainly put less emphasis on Georgist research and a group of Henry George-inspired individuals were considering legal action against the institute to push it toward its original orientation.

Other examples of explicit contracts binding nonprofits are more specific. Gifts often come with terms, i.e., a building for a particular type of medicine or a chair for Canadian studies. If the nonprofit grossly violates these terms, it leaves itself open to legal challenge. However, in most contexts, contractual incompleteness ensures that the nonprofit has a great deal of latitude in actually implementing the donor's wishes. An exception to this claim is that donors do seem to be effective at legally insuring that

their name remains attached to the gift. The model suggests that a desire for new donations, not legal contracts, keeps nonprofits oriented toward the desires of donors.

When there are not effective, explicit, legal restrictions, board membership tends to be the best means of ensuring that a nonprofit will follow the wishes of a past donor. However, boards themselves may find it easier to control some aspects of nonprofits than others. Boards will find it easy to monitor cash outlays and to make decisions about big construction projects. As Jencks and Riesman (2002, 16) said, originally more than thirty years ago, "Mistaken judgments about bricks and mortar are more obvious to the lay trustees than most mistakes in academic policy or personnel." They will find it extremely difficult to actually monitor the nature of services. This predicts that donors will be good at controlling new buildings, and will be good at holding down salaries, but they will be bad at determining what is said during lectures. Indeed, a major trend over the twentieth century is the rise in faculty autonomy over research and teaching. Another major trend in universities is the decline in board (or CEO) control over hiring and firing decisions. This trend again should be seen as an example of increasing worker influence over an area that boards find it hard to monitor.

While the boards of for-profit firms are ultimately elected by shareholders, the boards of nonprofit organizations resemble self-perpetuating oligarchies. In some cases, particular groups (such as alumni) have the right to elect members of a nonprofit board.[7] In other cases, large donations will be "rewarded" with board membership. However, even if a board is initially made up of representatives of the nonprofit's major donors, eventually this board will be replaced. The CEO usually plays a large role in selecting the new board members. As such, if the CEO is an elite worker at the university, then the CEO will be able to influence the selection of new members of the board to match his or her own preferences. The history of nonprofit organizations is rife with examples of boards that at one time were filled with representatives of the original donor, but later moved in some other direction.

Even in cases where board membership is passed along within a family, a donor's descendants' preferences will often differ from those of the original donor.[8] As time goes by, the goals of management will tend to follow their own paths and rarely seem bound by the wishes of the original donors. Modern universities may be swayed by the desires of new donors or

7. For example, in the case of Harvard University, the board of overseers is elected by alumni, but the Harvard Corporation is a self-perpetuating organization that selects its own members.

8. There is some evidence to suggest that the preferences of the children (and grandchildren) of philanthropists like John MacArthur or John D. Rockefeller are not all that close to the preferences of their parents.

alumni, but no one can look at modern universities and think that the desires of the original donors, who generally wanted to endow training grounds for the clergy, are being ardently pursued.

The degree of institutional wealth and worker autonomy will impact the nature of donations. Because donor control over rich nonprofits is often weak, donors who really want their money to be spent in a specific manner will start their own foundations instead of giving to wealthy nonprofits. Donors whose preferences are in line with those of elite workers at the nonprofit will continue to give. As such, the original donors to Harvard might have been motivated by a desire to train clergy. More recent donors are presumably more motivated by a desire to fund research.

Many donors also appear to be more interested in broadcasting their own wealth and benevolence than in changing nonprofit behavior. These donors should be particularly attracted to the largest nonprofits. In some cases, nonprofit endowments will have increasing returns, as large endowments serve as a guarantee of future survival and tend to increase the publicity value of donations. These particularly wealthy nonprofits will tend to have a comparative advantage with "signaling" donors because (a) their wealth often means that they can broadcast the signal to a wider audience and (b) their wealth guarantees permanence. As such, we should expect donations to weak and poor nonprofits to be driven by a desire to change nonprofit behavior, and we should expect donations to wealthy, strong nonprofits to be driven by a desire to broadcast wealth and benevolence.

Managerial and worker power both determine and are determined by the composition of donors. If a nonprofit reaches the stage where it can generate a steady stream of donations based entirely on the desire for eternal fame or on the desire to fund workers, then it will be relatively free to follow its own objectives without interference from donor wishes. However, if donors are primarily involved altruists, then the wishes of donors will tend to be quite important in the decisions of nonprofits. The independence of some universities and art museums probably has as much to do with their ability to raise donations, motivated entirely by a desire for fame, as by their endowments themselves.

Changes in B—the extent to which workers care about the nature of the product—will impact the choice of X only through the wage. As such, changes in B will increase the organization's income if $X > 0$ and if σ is high. Thus, the more that the organization favors workers, increases in the strength of workers' tastes will lead to decreases in the price of the wage bill and to increases to the extent that workers favor workers if the organization is already catering to those workers.

Finally, changes in K and P have two effects. First, an increase in P or a decrease in K raises the income available to the organization. This effect will tend to make the organization increase the value of X. Second, an increase in P or a decrease in K lowers the cost of output—this will tend to

make it more attractive for the manager to increase output and this will increase the desire for more cash, thus the importance of donors. Of course, if we get to the point where $P > K$, then the manager will increase output purely for the sake of making money.

The following corollary to proposition 1 follows directly from the fact that wages equals the reservation utility plus B times X.

Corollary to Proposition 2. *As long as* $\sigma < 1$*, then observed wages of workers in nonprofits will be less than if* $P(|X - X_C|) = P$*, and wages will be falling with C, D, and E and rising with d. The level of wages is falling with K and rising with P if and only if* $f'(N) > -Nf''(N)$.

This corollary implies that rich nonprofits may have low wages because workers are able to influence the organization's production processes. This result would change if the employees are also good at lobbying to get their nominal wage increased, but, as I have argued earlier, boards tend to be effective at limiting massive salary increases for workers. If workers can increase their wages, then there will be queues for jobs at particularly wealthy nonprofits. Indeed, any situation where $\sigma > 0$ will result in a situation where there are queues for entry into the organization because worker wages do not adjust fully to the higher level of amenities in nonprofits, we should expect to see workers getting some of the rents.[9]

I have so far discussed the ability of workers to influence managers during the everyday business of the managers' term of employment. It is also true that workers are able to influence the board to get managers who are friendly to their interests. As workers will generally serve on search committees, in part because their expertise is helpful in finding a new manager, they will also be able to get a manager with preferences close to their own.

The impact of the strength of the manager's preferences will depend on whether X is above X_M, or below X_M, or in other words, if the nature of the nonprofit looks more like an average of managers' and workers' tastes or more like an average of managers' and donors' tastes.

Proposition 3. *If second-order conditions hold, then an increase in the value of g will raise the value of X if and only if* $X_M > X$.

This proposition actually has some useful implications for the impact of a strong president. At a point in time where donors are particularly powerful (because D and E are small), X is likely to be low or less than X_M. In that case, an increase in g—a powerful president—will be likely to raise the value of X, to make the nonprofit more into a workers' cooperative and less

9. It is possible that in some cases worker control will lead to higher nominal wages in nonprofit firms. However, management is likely to take at least some advantage of their ability to hire cheaper workers.

into a donors' organization. Alternatively, in spectacularly rich and long-standing organizations, the value of X is likely to be high, and strong managers will find themselves fighting against workers, rather than supporting them. As such, in the early twentieth century, university presidents saw their goal as liberating the university from the control of the donors (in some cases, state governments). Men like Robert Maynard Hutchins at Chicago or Clark Kerr at Berkeley fought for their professors and generally opposed their donors and boards.

Today, presidents of well-endowed universities are often as likely to find themselves allied with their donors against their faculties. This does not occur because the views of the presidents have changed, but rather because the status quo value of X is much closer to workers' interests than to donors' interests, i.e., the increasing wealth of universities has made them much closer to workers' cooperatives than to donors' playthings.

One exception to this claim tends to be state universities. In these places, probably because (a) legislators care more about the nature of the university (i.e., have a higher value of d) and (b) because endowments are smaller, the universities have stayed closer to the interests of the donors (i.e., the state legislatures) and further from the interests of the faculty. As such, X is often below X_M, and strong university presidents find themselves trying to push the university toward more academic goals, rather than toward goals that are aligned with those of donors.

The influence of the idiosyncratic tastes of nonprofit CEOs implies that there will be much more variance in the methods and practices of nonprofits than is comparable for profit firms. The model implies that the level of X in for-profits will be determined by the demands of consumers and partially of workers. In some cases, for-profits will differ in their services to fit different product niches. However, they should not change their patterns in response to the whims of their CEOs. As such, the model predicts more variation from firm to firm and within firms over time in response to different managers.

Commercialism and Product Market Competition

I now turn to the topic of commercialism. The previous section dealt with the conflict between the goals of donors and those of workers. However, the interests of consumers also matter. When we think about nonprofits commercializing themselves, this tends to mean that they are taking the interests of consumers into account more strongly.

In the framework, these issues can be captured by different values of X_C. If X_C is negative, then the preferences of consumers differ from the preference of both donors and workers. If X_C is positive, then customers' tastes will lie somewhere between the tastes of workers and donors.

To simplify the analysis, I will analyze two cases which capture the intu-

ition of the differing scenarios. First, I consider where customers want the value of X to be as low as possible, and thus their interests are opposed to the interests of both donors and workers. This may well capture the reality in private hospitals, where commercialism tends to act against the wishes of both doctors and donors. Second, I will discuss the case where X_C lies between zero and 1, and thus customers' tastes lie between the tastes of managers and donors.

For simplicity, we will also assume that the interests of workers and management are perfectly aligned, i.e., $X_M = 1$, so that we can focus on a three-way (rather than a four-way) conflict between workers, donors, and customers.

$$(1') \quad C + g = f'\left[\frac{E + D + \sigma BX - dX \cdot I(X > 0) - \underline{W}}{K - P(|X - X_C|)}\right] \cdot \left[\frac{d \cdot I(X > 0) - \sigma B - P'(|X - X_C|) \cdot I(X > X_C)N}{K - P(|X - X_C|)}\right]$$

PROPOSITION 4. *If* $P(|X - X_C|) = P_0 - P_1 X$, *and if we assume that* $-(C + g)(K - P_0 + P_1 X) f''(N) > 2P_1 f(N)^2$ *so that second-order conditions hold, then*

1. The level of X will rise with E and D and fall with $\underline{W}$.
2. The level of X will rise with C and g. The level of X will rise with B and σ as long as X is not too negative. If X is not too negative, then the level of X will fall with d if and only if X is positive.
3. The level of X will rise with P_0 and fall with K as long as $K > P_0 + P_1 X - 0.25$.
4. The value of X will decline with P_1.

The intuition of the first result is that increases in wealth allow nonprofits to cater to their own preferences a little bit more. Technically, this occurs because income causes the number of units to rise and this decreases the marginal benefit per unit. As such, this predicts that decreases in wealth will tend to make nonprofit organizations more commercial.

Result (2) tells us that the desire to cater to customers will decrease when worker or manager preferences are stronger, or when workers have more influence over manager utility. This result is unsurprising and just suggests that noncommercial nonprofits will particularly appear when managerial or worker preferences are strong. The impact on donor preferences depends on whether X is positive or not. In either case, increases in d will make the nonprofit adhere more closely to donor preferences.

The third comparative static tells us that increases in the profit per unit sold will tend to make nonprofits less attentive to market demands. This effect works through the income effect discussed above. However, it is conceivable that increases in profitability can have another effect—they can increase the desire to produce more units. In this case, the nonprofit or-

ganization may cater to customers in order to raise income and increase the number of units produced.

Finally, the comparative static on P_1 is quite straightforward. I interpret higher values of P_1 as reflecting either stronger consumer preferences or greater product market competition. If the product market is particularly competitive or if customers are particularly interested in goods of a certain quality, then nonprofits are likely to cater to consumers' tastes. This helps us make sense of Barro's finding that university hospitals particularly took to advertising, a form of commercialism, in the 1990s. He argues that this can be understood because there was an increase in the marginal revenue from advertising for hospital nonprofits and less of an increase for other firms.

When X_C lies between zero and 1, the situation gets somewhat murkier. In that case, the comparative statics depend on whether X lies above or below X_C. Increases in wealth or increases in the strength of managerial or worker preferences will still cause X to rise. Increases in donor preferences will cause X to fall. Increases in the strength of consumer preferences will generally cause nonprofits to adhere more closely to the demands of consumers. As none of these results are all that surprising, I will omit a formal proposition.

This model has emphasized several points about nonprofits and the differences between nonprofits and profit-maximizing firms. First, nonprofits will be more oriented toward the desires of their elite workers than for-profit firms. In particular, nonprofits will cater to the workers who have direct contact with the CEO. This difference between nonprofits and for-profits will be most visible among the richest nonprofit organizations. As nonprofits become poorer, they will more closely resemble for-profit firms.

Second, nonprofits will offer lower wages than for-profit firms, unless worker control has cut off any labor market competition. These lower wages are compensating differentials for greater control over the working environment. Third, nonprofits will be less oriented toward the interests of consumers and their policies will be much less likely to shift with changes in consumer demand. This will depend on the degree to which there is profound product market competition. Four, nonprofits will on the other hand be much more likely to shift policies with changes in their CEO. Finally, nonprofit behavior is likely to show much more profound "income effects" than for-profit behavior.

Conflicts in Nonprofit Organizations

In this section, I focus on four areas of nonprofit organizations and discuss some of the history of these sectors. My interest is only in certain episodes of donor-worker or customer-worker-donor conflict, and I am not trying to give even a thumbnail sketch of the history of these sectors.

The Rise of the Modern American Research University[10]

In this section, I discuss the conflict between donors and faculty in the wealthiest universities. These comments are irrelevant for the majority of the higher education sector which is not well endowed.

Writing in 1968, Jencks and Riesman (2002) describe an "academic revolution" where early nineteenth-century colleges, dominated by the preferences of founders, donors, and customers, evolved into twentieth-century universities, which increasingly were dominated by upper level administrators and faculty. This transformation follows exactly the logic of the model. Nineteenth-century colleges were poor and because "financial solvency was so precarious . . . colleges responded to even the smallest external pressures and had only the most limited ability to reshape the priorities established by their supporters" (Jencks and Riesman 2002, 6).

In the twentieth century, a few colleges became rich, in part because of the increasingly important role of education in the modern economy and in part because of the increasing value of some endowments. These richer universities reoriented themselves to the preferences of upper-level administrators and faculty. As Jencks and Riesman (2002, 17) write: "What is perhaps unusual about the academic world is the extent to which the top management, while nominally acting in the interests of the board, actually represents the interests of 'middle management' (i.e., the faculty)." Of course, I have argued that this orientation is not particular to academia, but it is a general feature of wealthy nonprofits.

The wealthiest nonprofit universities were founded in the colonial period. As Morison (1935) describes, Harvard was founded by the General Court of Massachusetts with an initial grant of 400 pounds. John Harvard's own bequest came in his will in 1638 and appears to have been somewhere between 200 and 800 pounds. Contemporary observers, such as Governor Winthrop and Thomas Shepard, appear to have thought that Nathaniel Eaton, Harvard's first professor, absconded with the funds. Thus, from the first, the funding of America's universities appears to have been used in the interests of faculty (see Morison 1935 for details).

While there was certainly substantial secular education at Harvard, as Morison writes, "we should miss the spirit of early Harvard if we supposed the founders' purpose to be secular" (1935, 250). The ultimate goal of the university was certainly to propagate the Puritan faith. Indeed, the religious orientation of college persisted for centuries. Jencks and Riesman begin their book by writing that "during the seventeenth, eighteenth, and early nineteenth centuries, American colleges were conceived and operated as pillars of the locally established church" (2002, 1). They were

10. As is obvious from my quotation practices, my view of the changes in the modern university has been primarily influenced by Jencks and Riesman (2002).

funded by a combination of private donations (often given at death) and public funding. New colleges were founded by local entrepreneurs who responded to some combination of their own idiosyncratic passions and local demand, and these entrepreneurs often provided strong, occasionally overwhelming leadership.

Jencks and Riesman describe the world of the nineteenth-century colleges as being characterized by "self-confident trustees [who] tended to intervene in college affairs far more often and more disastrously than is usual today" (2002, 6). They continue and write that "nineteenth-century college presidents also tended to be far more domineering than they are today, carrying the business of the college around in their brief cases or even in their heads, entrusting very little to committees of faculty members of lower-level bureaucrats, and imposing their personal stamp on the entire college" (Jencks and Riesman, 6). Of course, in many cases, powerful presidents, like the University of Chicago's William Rainey Harper, were powerful because they acted in concert with founding donors, such as John D. Rockefeller. As such, control of the nineteenth-century university was shared between donors, the CEO, and customers.

Over the course of the twentieth century, two major complementary trends occurred that transformed research universities into their more modern incarnations: The most prestigious universities grew in both complexity and wealth. The rise in complexity meant that CEOs could not micromanage the entire organization and as such had to trust in subordinates. Naturally, a greater reliance of subordinates meant that these subordinates were able to influence the direction of the university. The rise in income meant that universities were freed from catering to the customers and donors. The net result, again quoting Jencks and Riesman, was that "most university presidents see their primary responsibility as 'making the world safe for academicians,' however much the academicians resent the necessary (and unnecessary) compromises made on their behalf" (2002, 17). By the late twentieth century, the university was "more concerned with keeping the faculty happy than with placating any other single group" (Jencks and Riesman 2002, 18).

The importance of university wealth in the transformation from donors' universities to faculty universities is well illustrated in the remarkable career of Robert Maynard Hutchins, who ran the University of Chicago between 1929 and 1951. Hutchins was highly idiosyncratic and also fundamentally oriented toward faculty preferences. The most glaring example of Hutchins's faculty orientation was his decision to shut down Chicago's extremely successful football program (the original Monsters of the Midway) because it distracted from more academic pursuits. Hutchins also created his Great Books program and ardently pursued his vision of the university as a "community of scholars." Hutchins had the freedom to pursue this vision because of the vast wealth of the University of Chicago. Because

of the generosity of the Rockefellers, the University of Chicago had the largest endowment in the country, and Hutchins could use it to pursue his own interests and those of his faculty. Of course, the downside of creating a true professors' paradise is the loss in donations that ultimately caused a massive reduction in the relative financial standing of the university.

Of course, the academic history of the late twentieth century also shows that university management is also vulnerable to the lobbying and influence of students. In the model, I assumed that only workers can punish the CEO. More realistic, I would have allowed current students to also cause pain to the administration. Indeed, the student riots of the 1960s and the current living wage sit-ins are examples of students exploiting their ability to cause pain to university administrators. These actions appear to be effective in influencing the behavior of nonprofit CEOs. It is hard to imagine that similar demonstrations would have been as effective in changing the behavior of General Steel or Exxon.[11] The weak incentives for nonprofit CEOs make them more vulnerable to this type of local influence.

Two examples of the power of faculty over the twentieth century are the institution of tenure and the rise of faculty research. The widespread existence of academic tenure only came in the mid-twentieth century. Appointments without fixed end dates existed before 1900, but in general, it was accepted that the president of the university could end these appointments virtually at will. In many cases, appointments were always explicitly for one year and reappointment was far from automatic. A hundred years ago, most colleges were sufficiently precarious that a lifetime commitment to a faculty member would have been a ridiculous encumbrance.

But faculty members, beginning at the turn of the century, made a concerted effort to get formal control over the dismissal process. For example, E. A. Ross, an economist, had been dismissed from Stanford because his left-wing views annoyed Jane Lathrop Stanford, the sole trustee of Stanford University at that time. When Ross was fired, he began a defamation campaign in the press against David Jordan, the president of Stanford (see Metzger 1973 for details). Ross's allies in the American Economic Association undertook an investigation of his dismissal. Jordan fought back, and Ross's dismissal was not reversed, but a concerted faculty effort certainly managed to impose pain on Jordan and on the university as a whole. During the early twentieth century, these types of tactics were regularly used by faculty members who were dismissed by their universities.

Eventually the faculty members won. In 1940, the American Association of University Professors (AAUP) and the American Association of Colleges agreed on a set of principles about tenure. By 1970, tenure was a

11. Of course, large-scale strikes can influence large corporations. But these strikes generally involve a large fraction of the workforce (often sit-ins are perpetrated by a tiny minority of the student body) and generally involve a focused change in workers' compensation.

fairly universal institution at four-year colleges. This was achieved through the actions of individual professors and through the power of the AAUP. As I have argued, the actions of unions and individual lobbying should be much more effective against nonprofits with weak incentives than against profit-maximizing firms. There is no major for-profit sector with an institution comparable to tenure.

Of course, the other ingredient that made tenure possible was growing university resources. As Metzger (1973) writes, "helped by enormous largesse from the states, steep rises in federal support, the seed millions of the Ford Foundation, the success of innumerable alumni fund drives, and public willingness to pay the tuition and other college attendance costs . . . the fortunes of judicial tenure rode high upon this arc." He continues: "wealthier institutions were able to consider the positive sides of tenure and not dwell on its alleged inefficiencies and money costs." Just as the model predicts, an increase in nonprofit wealth led to an increase in the orientation toward worker preferences.

Accompanying this change in status, professors also changed their work habits. The typical professor in an elite institution in the early twentieth century spent much more time teaching and much less time doing research than his late-twentieth-century counterpart. Then and now, professors in less well endowed institutions do more teaching, but there has been a significant change in the amount of time allocated to nonteaching activities. As Jencks and Riesman write,

> Until World War II even senior scholars at leading universities did a good deal of what they defined as scut work: teaching small groups of lower-level students, reading papers and examinations, and the like. . . . Today, however, few well-known scholars teach more than six hours a week, and in leading universities many bargain for less. Even fewer read undergraduate examinations and papers. (2002, 40)

Professors have been able to reshape their jobs to fit their own scholarly ideals.

Of course, some of this change reflects the growing market power of some professors, not lobbying for rents. However, teaching loads appear to be more closely correlated with the wealth of an institution than with the market power of the professor within that institution. The decline in teaching and the rise in research appear to have been shared among the faculty of wealthy institutions—these changes didn't just affect mobile faculty who were in demand. Ultimately, donors have been found to pay for at least some of this research, but in many cases, this seems more like an ex post adjustment to a new reality than a driver of change.

The story of twentieth-century universities appears to show that faculty members and elite administrators were able to exercise increasing control over increasingly wealthy institutions. A hundred years ago, universities

were still generally dominated by powerful donors and occasionally autocratic presidents. Presidential power still matters, but the ability of donors to dictate university actions has fallen since the days when Mrs. Stanford could get a left-wing economist fired on a whim. Academics have instituted tenure and gotten control over hiring and firing decisions. In wealthy institutions, they have managed to replace teaching with research. While boards have certainly stopped extreme looting of the university by its workers, it is hard not to be impressed with the general success that elite workers have had in taking control of nonprofit universities and colleges.

An alternative interpretation of the change in universities is that this was just a response to a changing market. In 1900, students did not care about having researchers as faculty members—in 2000, they do. While there may be some truth to this claim, ultimately it seems difficult to accept that the switch to research was really motivated by a desire to cater to students. In part, the best counterexample is the continuing success of teaching colleges throughout the United States.

Teaching colleges generally operate with significantly lower endowments and much less state aid than large research universities. Instead, they require much more from their teachers and allow them much less free time to do research. While it is true that the top universities are more popular than any teaching colleges, top teaching colleges, such as Amherst or Haverford, are able to compete easily with many research universities and to give many fewer perquisites to their professors. If research was such an important component of consumer demand, then students would always prefer the University of Rochester or the University of Chicago to Williams. They do not.

Indeed, the history of teaching colleges reminds us that there are cases where elite workers are not able to dominate schools. In places with smaller endowments, schools end up requiring much more from teachers and giving them much less in terms of both amenities and income. The extreme example of this tends to be private high schools (at least those without large endowments). In these schools, teachers work for generally quite low sums. They have little control over the direction of the school, and donors and parents tend to dominate. Worker control is not inevitable in nonprofits, and greater financial need severely limits the ability of workers to reorient the institution's mission.

The Rise and Fall of the Doctor's Cooperative

The first half of the history of the hospital strongly echoes the history of the university. Between 1800 and 1950, hospitals evolved from being charitable institutions dominated by their donors and oriented toward the poor into being the "physicians' cooperatives" described by Pauly and Redisch (1973). As Rosenberg (1987, 7) writes, "the perceptions, the values and rewards, the career patterns, and, increasingly the specific knowledge of

physicians have structured this development [of the hospital]." Starr (1982, 146) agrees: "Authority over the conduct of the institution [the hospital] passed from the trustees to the physicians and administrators." In the case of hospitals, though, there is a second act where increasingly financial pressure has led to commercialism and to a decline in the autonomy of physicians and professional administrators.

Hospitals begin in America in the eighteenth and early nineteenth centuries as charitable institutions for the indigent. The early hospitals, such as Pennsylvania Hospital (founded in 1752) or Massachusetts General Hospital (1821), were "something Americans of the better sort did for their less fortunate countrymen" and where "the worthy poor would find an opportunity to recover outside the almshouse's demeaning walls" (Rosenberg 1987, 20). Starr (1982, 145) writes that "from their earliest origins in preindustrial societies, hospitals had been primarily religious and charitable institutions for tending the sick, rather than medical institutions for their cure." He also emphasizes that "in the nineteenth century, the trustees or managers entered directly into the detailed operation of hospitals, including decisions that now would be seen as strictly medical" (153). For example, in many hospitals, donors determined who would be admitted. Like early universities, early hospitals were dependent on donations, and, as a result, donors wielded a great deal of authority.

Even at this early stage, though, it was understood that hospitals served in part as educational institutions for physicians. Rosenberg writes that "education has always played a prominent role in the American hospital" (1987, 190). Some physicians volunteered to work in hospitals out of a combination of desire for experience and philanthropic impulses. Unlike teachers, who were unlikely to have the ability to subsidize hospitals, doctors were also donors and as such had some donor-like control even in the earliest hospitals.

But over time, the medical control of hospitals grew and ultimately changed the very nature of these institutions. Starr (1982, 145) evocatively writes that "in developing from places of dreaded impurity and exiled human wreckage into awesome citadels of science and bureaucratic order, they acquired a new moral identity, as well as new purposes and patients of higher status." By 1900, hospitals had focused on elite private patients. They were centers of elite medicine and were significantly involved in teaching and research. As Rosenberg (1987, 262) writes, by 1900, "the hospital had become easily recognizable to twentieth-century eyes."

For our purposes, the most striking shift is the degree of medical control over hospital operations. In 1825, the trustees of Massachusetts General had entrusted the management of their hospital to Nathan Gurney, a retired sea captain. As Rosenberg (1987, 262) writes, "the possibility of appointing a physician as superintendent was not even considered." Early trustees feared that doctors would put their professional objectives first

and the preferences of patients second. This situation corresponds to the situation in the model where donors and customers are arrayed against elite workers. Over the nineteenth and twentieth centuries, the relative power of trustees and doctors shifted: "Admissions, appointments, and control of teaching were all areas of conflict between lay and medical authorities—and all areas in which laymen gradually retreated and left the field to their medical staff" (Rosenberg 1987, 263). The modern hospital is an outcome of the increasing power of doctors, who shaped the hospital toward their own interests.

Why did doctors come to control hospitals? Like universities, the rise in doctor-controlled hospitals had much to do with increasing wealth. However, the wealth of twentieth-century universities came primarily from the generosity of donors. The wealth of twentieth-century hospitals came more from commercial activity that became profitable because of changes in medical technology. These technological changes made doctors more effective and increased the medical value of hospitals. The biggest early innovations appear to have been improvements in avoiding infections during surgery. These improvements specifically favored specialized locations for surgery (as opposed to surgery at home) and came to increase demand for hospitals. The rise in specialization also favored hospitals where large medical staffs could share their expertise in caring for the sick. These changes increased the demand for medical care and the wealth of both hospitals and doctors. Given the more central role that doctors played in generating income for hospitals relative to faculty in universities, it is not surprising that they came to dominate these nonprofits at a somewhat earlier time period.

Doctors' control did not just reflect their financial muscle. They were able to influence the way that all of the hospital's financial resources were used, including those contributed by donors or the state. Because doctors actually handled the day-to-day operations and because they were the workers who interacted with the superintendent regularly, they naturally became able to exert influence. Moreover, the increasing specialization of medical knowledge meant that retired sea captains no longer had sufficient expertise to run large hospitals and that doctors and later professional administrators themselves became superintendents. As in the case of universities, the weak incentives present in nonprofits meant that the elite workers were able to redirect the institution toward their own goals.

Of course, doctors are not the only powerful hospital employees. Starr (1982, 178) argues, following Charles Perrow, that "medical domination of hospitals began to weaken in the thirties and forties, as challenges from administrators to the authority of physicians became more common." This again echoes the rise in power of the upper-level administrators in universities. Hospital administrators, like their university counterparts, became the workers who interacted most often with the CEO (often pro-

viding the CEO), and, unsurprisingly, they became an influential group of elite workers.

But the control of hospitals by doctors and administrators has eroded significantly since 1980, and the primary reason for change has again been wealth. Sloan (1998) describes the bevy of negative income shocks that have occurred during the past twenty years. Government payments for Medicare and Medicaid have become less lucrative. Health maintenance organizations have sprung up and replaced traditional fee-for-service insurance. As a result, hospitals have considerably less ability just to set their own fees. Skyrocketing costs associated with changing medical technology have also greatly increased the price of being a hospital. As a result, the amount of rents available to nonprofit hospitals has shrunk dramatically.

In some cases, this has led nonprofit hospitals to close. While Hansmann, Kessler, and McClellan's chapter shows that nonprofits are slower to shut their doors than for-profits, there has still been a significant reduction in many areas in the number of nonprofit hospital beds. Another trend has been the conversion of nonprofit hospital to for-profit status. This trend is investigated by Cutler and Horwitz (1999). This is surely the ultimate example of commercialism.

More subtle examples of commercialism in nonprofit hospitals also exist. Weisbrod (1998) describes a wide array of nonprofit hospital behavior that appears to mimic for-profit firms and that appears to be a response to decreasing profit margins. The doctors' cooperative, described by Pauly and Redisch (1973), can only exist if there are substantial rents to be directed by workers. As these rents disappear, hospitals have become more like for-profits firms and this is exactly what the simple model predicts.

Connoisseurship in Art Museums

The case of art museums also fits the general patterns. The large museums began with large bequests from donors, who generally exercised a great deal of control over the collections. Over time, curators began to exercise an increasing amount of dominance in the running of museums. As museums became rich, curators got independence from their donors, and they began to orient collections toward their own objective—displaying their own curatorial competence. Still, museums probably look more like donor-run enterprises than do either universities or hospitals. The continuing power of donors comes from the relative simplicity of museum operations, which makes it easier for donors to give bequests that are bound by legal restrictions. The power of donors also stems from the extremely high ratio of physical to human capital and from the fact that nondonation museum revenues are extremely small relative to the nondonation revenues of hospitals and universities.

Art museums in the United States sprang from the wealth of the Gilded Age. Collectors, like J. P. Morgan, Andrew Mellon, and Isabella Stewart

Gardner, used their wealth to collect vast troves of European art. At first this art was in their own private collections. Then, motivated by some combination of a desire to elevate public tastes and to enhance their own prestige, they turned their collections into public museums. In many cases, their collections were turned over to museums when they died. These gifts enabled the collections to stay intact and free from the impact of estate taxes. As such, the wealth of museums, like the Metropolitan (which received a great deal of Morgan's magnificent collection) and the National Gallery (which relied on Mellon's paintings), came from socially elite art owners who wanted to preserve and show off their collections in perpetuity.

Occasionally, these gifts came with strong legally binding limitations that still impact the collections. Museums built around a single collection, such as the Frick Gallery in New York or the Barnes Foundation in Philadelphia, were the most restrained. In those cases, the donor had the most freedom to craft the bylaws of the foundation and the greatest ability to influence future actions of the museum. So for example, both the Frick Gallery and Barnes Foundation have restrictions that block the extent to which their art can travel. Both museums have severe restrictions that block the selling of existing paintings. In the case of the Frick, the gift of art was accompanied by a large cash endowment as well, so these restrictions have not been all that problematic. However, the Barnes endowment came with paintings but not enough cash to actually support the museum (at least in the manner that the Barnes' curators think that the museum should be run). As such, the restrictions placed on the paintings actually severely influence the operations of the museum.

In many cases, the private donors were also supported by some degree of direct governmental involvement as well. In the case of the National Gallery or the Metropolitan Museum, the government was involved in bequeathing either direct or indirect subsidies to the museums. In some cases, the government really directly runs museums as public enterprises. In other cases, universities run museums and have their own interests at play.

Over the course of the twentieth century, the power of curators generally increased. Figures, such as Thomas Hoving at the Metropolitan, used the increasing wealth of their museums to pursue their own agendas and were often at odds with their wealthy trustees. A classic example of rising curatorial independence was Hoving's show *Harlem on My Mind.* This exhibition showcased pictures of Harlem's architecture and focused on social conditions in the neighborhood. It was a flamboyant gesture with adverse political consequences that did little but cause pain to the museum's wealthy donors. This type of curatorial showboating was typical of Hoving's tenure. In a sense, he was the museum equivalent of Hutchins, who pushed his own agenda, which was deeply tinged by his curatorial ambitions, rather than the goals of the trustees.

A particularly frequent area of dispute between curators and donors is the organization of collections. Generally, curators like to design collections around historical periods and themes which can highlight their own vision. Donors, on the other hand, like to keep their collections intact. Presumably, their goal is also to highlight their own artistic vision. In most cases, the curators have won. Museums rarely highlight their donors' visions, except in extreme cases like the Frick and the Barnes. However, there are cases, such as the Lehman wing at the Metropolitan, where donors are able to keep their collections intact through an explicit legal contract with the museum.

Another area of conflict between donors, curators, and customers, which the Goetzman and Oster chapter in this volume highlights, is the degree of accessibility of the museum to the general public. Museum fees are one way that the museum controls the inflow of observers. However, fees may be far from the most important attribute of the museum. Collections can be designed in a particularly user-friendly manner in which the nature of the art is made accessible to a wide range of the public. Once again, Hoving was the aggressive pursuer of a more open vision of the museum.

Ultimately, museum attendance in some cases serves to provide nondonation revenues that can free curators from their reliance on donors. The extreme example of this is "blockbuster" exhibitions that have been designed in a very user-friendly manner and tend to attract a very large audience. These blockbusters are a relatively recent phenomenon, but the large revenues that they generate may be a portent of things to come. If museums can generate sufficient revenues from this source, it seems likely that they will end up being more curatorial in their orientation and less oriented toward donor demands.

All in all, museums show some of the same features as the other nonprofits. Generally, they have become oriented toward their elite workers and away from their donors over time. However, the extreme reliance of museums on donor financing means that museums are still much more dependent on their donors than other nonprofits, and, as such, donors continue to wield significant power.

The Medieval Church

At this point, in the spirit of the Nelson and Zeckhauser chapter in this volume, I stray considerably from twentieth-century America to the rise of the medieval church. A thousand years before elite workers were able to wrest some degree of control over universities, hospitals, and art museums from lay donors, the clergy fought and won a battle with their lay sponsors. This battle has all of the trademark features that we see in these modern nonprofits. Increasing wealth in combination with the ability of elite workers to directly influence top management leads to a reorientation of the institution toward workers and away from donors.

The medieval church shares several elements with the nonprofits we have already discussed. Officially, the Catholic Church's CEO (the pope) was formally elected by the College of Cardinals, a self-perpetuating group of elite workers in the church, and, indeed, the Pope had some authority even at the turn of the last millennium. But 1,000 years ago, wealthy donors generally had significant say over appointments and indeed over church policy itself. Like hospital donors, who controlled admissions, and university trustees, who could dismiss professors, local kings and noblemen often had the right to appoint and, if necessary, dismiss local bishops and clergymen. Indeed, laymen generally appointed the pope throughout the tenth and most of the eleventh century. For example, in 1046, at the Synod of Suri, the Holy Roman Emperor Henry III removed the existing pope, Gregory VI.

At the end of the eleventh century, Gregory VII began an extremely bitter conflict with lay authorities to establish clerical control over the church. The most important area of controversy between cleric and donor was lay investiture—the appointment of bishops and other clergymen by lay authorities. This policy led to significant lay control over church policies. After all, if the emperor chose the bishops, then surely he controlled much of the course of the church. Lay investiture also led to a significant transfer of resources from clergymen to nobles. In general, nobles would charge the clergy for the right to be appointed. The unsurprising use of power to extract rents was condemned by the papacy as the sin of simony.

The opening salvo of the war between the pope and lay authorities occurred in 1075, when Gregory VII, in a remarkable display of papal autonomy, announced the end of lay investiture and defrocked clergymen who had paid for their offices. Gregory had a remarkable prepapal career as the reformer Bishop Hildebrand, and he was the first non-German pope since Henry III had started appointing popes in 1046.[12] The emperor, Henry IV, used his ability to influence German bishops to try and depose the pope. Ultimately, Henry would humble himself at Canossa, and accept some limits on investiture. The pope's victory was actually due to support from the Hohenstaufen's lay Saxon enemies who were eager to use this religious conflict as an excuse to depose the emperor.[13] Still, the emperor was powerful enough to exile the pope to Salerno, where he died.

The conflict over investiture would last for centuries, but ultimately the papacy would free the church from most lay authority.[14] While the conflict between pope and emperor was surely the most important early battle,

12. The fact that Henry III's son Henry IV became emperor while he was a child certainly contributed to the move toward papal independence.

13. Henry's Saxon opponents were Welfs, while Henry was a Hohenstaufen. The famous Florentine parties of the Guelfs and the Ghibellines are linguistic descendants of the Welfs and the Hohenstaufens.

14. However, it is worthwhile emphasizing that the Emperor's eventual heir, the Austrian emperor, was still seen as having veto power over the choice of pope as late as the twentieth century.

conflicts over investiture and clerical authority occurred in many countries. For example, the famous battle between Thomas á Becket and Henry II of England concerned secular authority over priests. In 1302, Boniface VIII faced off against Philip the Fair of France. After Boniface issued a papal bull announcing papal supremacy, Philip demanded his trial as a heretic. Ultimately, the French would at least temporarily win as they moved the papacy to Avignon.

But overall, the movement was toward increasing clerical control over the church. Popes, like Innocent III, managed to increase the wealth and authority of the papacy substantially. The land holdings of the church increased. By the fifteenth century, the time of the Nelson and Zeckhauser chapter, the papacy had moved back to Rome, and the church had finally gained some measure of independence from secular authorities. Under a succession of popes, starting with Martin V, the church became something like its modern, more independent form: Lay investiture disappeared, clerics achieved control over church policy, and ultimately the church became oriented toward the interests of priests, not kings and nobles.

Within the church, the Curia, the pope's court, came to dominate during this period. During the earlier medieval period, local bishops enjoyed a significant amount of autonomy. As the power of the pope increased, the powers of the clergy who were closest to the pope also increased. The result was that the Catholic Church became increasingly Roman. Theological unity, based generally on the opinions of Roman clerics, drove out previous diversity. A particularly strong example of this was the Albigensian crusade where Rome crushed the Catharist heretics in the South of France. Orders of mendicant friars, such as the Dominicans and Franciscans, who were obedient to Rome, not to local bishops, became increasingly important and further served to extend the reach of the Roman clergy throughout Europe.

Why did the papacy and the Roman bishops eventually win control? There are two obviously important factors that created independence. The first was the increasing wealth of the church. A rich variety of innovations and the growing wealth of Europe, generally, had increased the wealth of the Papacy. The sale of indulgences, taxes on clergy, and general levies imposed to fund the religious wars all filled the papal coffers. The crusades also were a source of papal funds. An increasingly competent papal bureaucracy was able to enforce these rent extractions.

The second factor was the ability of successive popes to play off European leaders. In a number of major political crises, the pope's support was seen as an important edge. Popes, such as Innocent III, were able to wring extractions from secular leaders in exchange for support. The rise of the nation state was accompanied by an increasing emphasis on legal forms and the appearance of legitimacy: While an eighth-century monarch generally relied only on his swords for dominance, thirteenth-century kings

increasingly needed less bloody forms of support. Thus, political division and an increasing emphasis on quasi-legal institutions acted as an income shock to the papacy. Just as in hospitals and universities, clerics were able to take control of the church as the independent wealth of the church rose.

Of course, there is a striking postscript to the rise of clerical independence. Just as the papacy appeared to have control over the church, the Reformation tore Christendom in half. While there are certainly intellectual elements to the Reformation as well, much of the early political support for reformers came from secular rulers who were eager to take back the authority that they had lost to Rome. Henry VIII is the most obvious example of a ruler for whom the reformation was little more than a bald attempt to seize lost royal prerogatives, but the German princes who supported Martin Luther were probably no less selfish. Ultimately then, the Reformation stands as a warning to nonprofits who try to establish too much independence from their donors. It is likely that these donors will find alternative nonprofits to support.

The past 200 years have also seen many episodes of increasing worker power in a number of churches. Within the United States, the Catholic Church eliminated lay appointments in 1845. In the richly competitive world of the American churches, there actually appears to be something of a lifecycle. New faiths are open to lay preachers and the clergy is essentially powerless, as free entry and lack of organization prevents clerical rents. As churches grow, they acquire wealth, and the clergy organizes and manages to gain some degree of control. With this control comes barriers to entry into the priesthood, such as seminaries, that stop lay competitors. Furthermore, the churches often tend to reorient themselves away from their lay people toward clerical comfort.

Papers in the Volume

The volume that follows explores the governance of nonprofit organizations. It contains seven chapters: two on art museums, three on hospitals, and two on nonprofits generally. The first two chapters in the volume concentrate on donor-worker interactions in nonprofits and the incentives of different actors. Hansmann, Kessler, and McClellan examine the closure decisions of different hospitals. As discussed above, one of the implications of the model is that nonprofits will continue to produce when there are negative profits. For-profits generally will not. This gap stems from the ability of nonprofits to subsidize production out of donations and endowment and from the occasional inclination of nonprofits to overproduce.

In particular, the decision to close seems likely to really matter to the workers at a nonprofit institution. Closures are almost surely going to include layoffs and a substantial loss of welfare to the workers. As such, if workers are able to influence management, we should expect management

to be particularly influenced to fight closures. Furthermore, some closures are likely to include managers themselves losing their jobs—something managers are likely to oppose. As such, the closure decision is an area where we should really expect the weak governance of nonprofits to matter. Nonprofits with substantial endowments and weak governance are likely to cater to their workers and stay open when comparable for-profits are likely to close.

Hansmann, Kessler, and McClellan look at the responses of hospitals to changes in local demand. They look at exogenous shifts in an area's population of Medicare-eligible population. This population represents one of the more lucrative populations of potential hospital clients, and, in principle, hospitals should be expected to rein in capacity when this key population falls. Hansmann, Kessler, and McClellan compare different ownership groups: for-profit and nonprofit hospitals. They find that both types of hospitals respond equally to increase in demand, but decreases in demand create a greater decline in for-profit than in nonprofit hospitals.

They can then further distinguish between different types of nonprofit hospitals. Religious hospitals appear to contract more readily than secular nonprofit hospitals. This may occur because there is residual claimant in the case of religious hospitals (the church) that imposes some discipline on these hospitals. In the framework of the model, it might be that in the case of religious hospitals (presumably with the chief officers in the church), management ultimately is not nearly as strongly opposed to closures as top management in nonprofit hospitals. Cardinals will not lose their jobs if a hospital shuts down—chief executives of hospitals will. As such, the differences between secular and religious hospitals again emphasize the importance of weak governance in the decision making of nonprofit firms. Although donors who care about overall national health would presumably prefer it if the resources of a hospital in a declining area were used elsewhere, managers will tend to keep the hospital open.

Goetzmann and Oster examine the donor-management conflict in the area of art museums. They emphasize that art museums serve three constituencies: donors, curators, and the public. Donors, they argue, seek social prestige through the prominent placement of donated art. Art museum workers and managers are generally connoisseurs who care primarily about preservation and perhaps their own research. Presumably, the public is particularly interested in the entertainment value of the museum experience.

In their view, the relative power of these constituencies will tend to differ across museum types. Free-standing nonprofit museums will generally be the most oriented toward the interests of their donors. As the model suggests, though, this orientation will probably decline as the wealth of the museum rises. University museums are likely to be the most free from donors or any other concerns. Their managers will be beholden to the man-

agers of the university, not to donors. Finally, public museums will have the most obligation to serve the voting public. As such, Goetzmann and Oster predict that university museums will be most engaged in connoisseurship activities, free-standing nonprofits will serve their donors, and public museums will charge low entrance fees and try to attract large audiences.

They are able to test this prediction using attendance data. They find that collection size and location influences attendance, but governance also matters. Public museums have significantly higher attendance levels than their private competitors. Free-standing nonprofits have the next highest attendance levels, and university museums have the least attendance. This exactly fits a model where university museums are the least oriented toward customers (and the most toward their elite workers) and public museums are the most customer oriented.

Importantly, they also find that the attendance elasticity with respect to the value of the museum collection is far less than 1 (about 0.26) across the entire sample. Perhaps this should be compared with an expected benchmark elasticity of 1—twice as many paintings, twice as many visitors. The model predicts that richer museums will be less oriented toward the public (and more toward workers). As such, we should expect attendance to rise with size of collection far less than one-to-one because the richer museums are less oriented toward catering to the public and more oriented toward the interests of their curators.

Interestingly, the university museums appear to have found an alternative source of funding that relies on their connoisseurship—traveling shows. While the real blockbusters are the product of wealthy free-standing nonprofits with the most important pieces, university museums appear to have a disproportionate share of the midlevel shows that are designed around important artistic themes. These shows are generally time intensive and serve the interests of the curators who design them. As such, we should probably not be surprised that it is the university museums that specialize in them.

The next two chapters examine different forms of "commercialism" in nonprofits. Barro looks at the rise of hospital advertising over the last ten years. There has been a striking rise in this particularly commercial form of activity among hospitals since the early 1980s. This rise appears to go against traditional medical biases against advertising, and it represents a striking, new attempt of hospitals to reach out to consumers.

The model, discussed above, suggests that this type of commercialism might tend to show up when hospitals are in trouble financially, but this is not what Barro finds—instead, it is the wealthiest, teaching hospitals. In particular, these hospitals are advertising in markets with big HMOs. It seems that this is meant to increase their bargaining power vis-à-vis HMOs. Thus, hospitals that do have high-quality doctors and facilities are

trying to market themselves directly to consumers to eliminate some of the monopsony power held by large HMOs.

This chapter is interesting in that it helps us to understand this dramatic shift in nonprofit behavior, and it emphasizes that commercialism is not necessarily a response to poverty but sometimes a response to wealth. In this case, the teaching hospitals invested in quality, probably (as discussed above) because they were responding to the interests of their elite workers. However, this quality turns out to complement advertising, a "commercial" activity. The high-quality firms have a greater incentive to broadcast their quality than the low-quality firms. As such, large endowments may, in some cases, tend to make the firm ultimately more commercial (at least by some measures) than small endowments.

Erus and Weisbrod look explicitly at bonuses within nonprofit organizations. These are important because they directly look at the incentives being placed on nonprofit managers. Changes in bonuses over time, especially if those bonuses are related to organization profitability, can also be seen as increases in the level of commercialism.

Erus and Weisbrod find that bonuses became widespread in nonprofit hospitals over the 1990s. They were rarer in religious hospitals, which appear to follow a more classic pure-salary approach, but in nonprofit hospitals as a whole the prevalence of bonuses appears to rival the prevalence in for-profit hospitals. They suggest that this increase in bonuses may well be the result of increasingly tough market conditions in hospitals, which, just as the model above predicts, will tend to eliminate the freedom of managers to follow their own objectives and will instead reorient them toward profitability.

Nelson and Zeckhauser take us back to Renaissance Florence to understand the role that donor-church relationships played in the creation of some of the world's greatest art. They document that the building of churches in the Renaissance was a relatively decentralized affair. Local leaders, in combination with some members of the clergy, would decide to finance the public good of a local church. The bulk of this financing would be found by selling private chapels. These chapels were paid for entirely by private families who would both decorate the chapels and would pay for masses at the chapels that would be said for themselves. In general, these chapels would not be open to the public.

The architectural importance of this type of financing appears to be significant. By necessity, chapels needed to be ringed by private chapels to pay for the public aspects of the construction. As such, there was a division between private and public space in these churches. There was also a divergence from the simpler forms of design that were more common during the Romanesque period.

In a sense, the Nelson and Zeckhauser chapter reminds us of the fasci-

nating ways in which nonprofits are able to induce donors to contribute to things to which donors have little personal attachment. Because the donors want the religious returns from chapels and the social prestige of a prominently placed chapel, the church is able to use their funding to subsidize a more general public worship space. The donors themselves appear to have little interest in the existence of that space directly, but they certainly appear to have valued the social prominence that a large, visible chapel created for them. In a place like Florence, where political institutions were fluid and dependent upon local prestige, prominent displays of wealth (and benevolence) could perhaps even finance themselves by providing a basis for political power.

By taking us to the roots of nonprofit organizations, Nelson and Zeckhauser may help us to see that the essence of many nonprofits lies in providing an opportunity for the wealthy to display their resources and benevolence. In a sense, the provided service may actually be pretty secondary and really only a way to get the public in the door. The key client of the nonprofit is the donor who is willing to provide large sums of cash as long as the money is tastefully displayed and as long as the donor is guaranteed that his generosity will be well observed. This characterization is perhaps extreme, but it does seem to fit many typical modern donor-financed nonprofits including art museums, universities, and some hospitals.

Malani, Philipson, and David present an overall synthesis of the approach to nonprofit organizations and stands, in a sense, as an apt conclusion to the volume. They divide the existing theories of nonprofit organizations into three categories: (a) the altruism model, (b) the worker cooperative model, and (c) the noncontractible quality model. The altruism model loosely follows Newhouse (1970) and Lakdawalla and Philipson (1998). It argues that nonprofit organizations can be characterized by preferences over quality and quantity of output and that generally nonprofits prefer more of both. This fits nicely with the governance model where the nonprofit managers care about both of these attributes.

Their second theory is the worker cooperative model, which clearly adheres most closely to the work of Pauly and Redisch (1973). According to this model, the organization maximizes net revenue per worker. While their model assumes that workers focus on "wages," this view is a close cousin of the model discussed above where workers are able to orient production toward their own needs and interests. The classic result of this model is that because worker cooperatives maximize average revenues instead of total revenues, they will have lower levels of employment and lower levels of production than for-profit firms.

The final theory is the noncontractible quality theory advanced by Hansmann (1980), Weisbrod (1988), and Glaeser and Shleifer (2001). This theory argues that nonprofits have an advantage because of the weak in-

centives that are inherent in the nondistribution constraint. As such, nonprofit organizations are better at ensuring that they will not cheat on providing high-quality goods than are for-profit firms, and, in some cases, this will enable the nonprofits to be able to charge higher prices. Variations on this theory argue that nonprofits are also safer for their workers, or other investors in some cases, because they are less likely to have strong incentives to expropriate. As such, workers may be more willing to invest in firm-specific human capital with nonprofit organizations because they believe that it is less likely that the nonprofit will later expropriate their investment.

Malani, Philipson, and David present a simple model that integrates all of these views and then look at the different predictions of the different models about the differences between nonprofit and for-profit firms. While this approach has many advantages, it suffers from the fact that it is hard in industries that do not have both for-profit and nonprofit firms. Three examples of their approach give the style of this chapter.

First, they discuss the implications of the different theories for firm size. The noncontractible quality model tells us little about the expected firm size of the nonprofit, but the other two theories do indeed give us contrasting implications. The altruism model predicts larger firm sizes, at least holding quality constant, because the nonprofit organization directly cares about the scale of production. The workers' cooperative model predicts that there will be fewer workers and smaller firm size, at least holding capital constant, because the number of workers at which average revenue per worker is reached is less than the number of workers where total revenues is maximized. The existing studies appear to confirm that nonprofit hospitals and nursing homes tend to be bigger than their for-profit counterparts. This presents some evidence for the altruism model. This can fit into the discussion above where firm size might be larger in nonprofits because of the manager's preferences for size (which is exactly the same as the Newhouse 1970 model), even if adhering to workers' preferences leads to at least some drop in size (relative to a donor-controlled firm).

The different models also give different predictions about the quality of care. The noncontractible quality model predicts that nonprofits will have higher levels of nonverifiable quality. The altruism model predicts that nonprofits will have higher levels of all forms of quality, because, after all, the managers directly care about the quality of care. Empirically, most studies find little difference in the quality of care across different ownership types. This evidence does not square all that well with any of the models.

A final example of their approach is their examination of pricing in nonprofit and for-profit firms. Here the models diverge again. The noncontractible quality model predicts that, holding observable quality constant, for-profit firms will generally charge more in recompense for their higher quality levels. Alternatively, the altruism model predicts that prices will be lower both as a result of altruism for customers and also to increase ca-

pacity utilization. The governance approach will also tend to predict lower prices, but in this case prices might be lower because low prices and queues make it easier for incumbent workers than trying to push the product hard at the true market wage. In the hospital context, the evidence on prices is limited but appears to be mixed. Some evidence suggests that once you adjust for quality, the nonprofits have a slight price premium that appears to be waning over time. Other evidence suggests that nonprofits charge a lower price in the health sector. Certainly, in the educational sector it is hard to argue with the view that nonprofits often charge below market rates and attract queues.

The final chapter, by Fisman and Hubbard, explores the endowment effect. In the model, I took endowment as fixed, but this is clearly a mistake. The level of initial giving will itself take into account the impact of that giving on later actions by the nonprofit.

Fisman and Hubbard explore the role of endowments. They emphasize that endowments have two roles. First, as discussed above, they lead nonprofit organizations to follow their own objectives instead of the objectives desired by donors. Second, endowments protect foundations from the winds of fate. As such, endowments create permanence in nonprofit organizations and make them more likely to survive. Hubbard and Fisman emphasize this trade-off between alleviating risk and governance.

Of course, this raises the question about who is determining the size of the endowment. If we think of endowments as the result of the management of nonprofits' saving, rather than spending, current earnings, then endowments will be attractive both because they insure against future shocks and because they give independence to nonprofit management. Presumably the cost of endowments, to managements, is that they represent forgoing current expenditure. As such, endowments should probably be seen as a classic form of savings.

If we think of endowments as being the result of donors' decisions to contribute to an endowment rather than to current spending, then the puzzle becomes a little more difficult. Why would a donor ever give money all at once rather than dribbling it out over time? Presumably, the donor always maintains more control by keeping the money in his or her own bank account rather than by giving to the nonprofit. Of course, endowment gifts at the time of death are presumably less puzzling. At that time, donors really have no option of continuing to keep control over the gift.

One possible explanation for donors giving to endowments all at once instead of giving a slow flow of gifts is that this type of gift represents a firm commitment to the nonprofit, which may attract other donors.[15] If the attraction of nonprofits is intimately linked to their permanence, perhaps be-

15. Of course, in many cases a larger endowment may reduce the flow of future donations because it reduces the marginal impact of any new donations (see Glaeser and Shleifer 2001).

cause of the selling immortality aspects of donations, then a large endowment may end up attracting other donors. As such, endowments are a commitment device by one donor to make the long-term viability of the organization more obvious to others and hopefully to elicit more donations.

While Fisman and Hubbard do not necessarily answer all of the questions about the determinants of nonprofits, they do give us two key empirical clues about endowments. First, they find that endowments are higher in sectors with more income volatility. This evidence strongly supports the precautionary savings view of endowments. Whether endowments are determined by nonprofit management or by donors (or by a combination of both), we should expect to see larger endowments in riskier areas, and that is what they find.

Their second finding documents a connection between measures of governance and the size of endowments. They find that in states where donors have more control over the actions of nonprofits, endowments tend to be larger. This result should probably be interpreted as meaning that donors understand that by endowing nonprofits they are ceding independence. As such, they will be more likely to give endowments if there are other checks on the actions of nonprofit organizations.

Conclusion

Nonprofit organizations have governance problems that resemble the problems in for-profit firms, but are often far more extreme. In both nonprofit and for-profit firms, investors have trouble ensuring that the firm's decisions maximize the investors' welfare. However, the market for corporate control and the ultimately democratic nature of for-profits, gives investors in for-profit firms and shareholders much more power than donors. In nonprofits, the preferences of management end up being far more important and in most cases, nonprofits end up being quite independent of their original investors—the donors. This independence becomes particularly extreme in the wealthiest nonprofits that have large endowments with which to support the preferences of their managers. Poorer nonprofits find it more necessary to either cater to customers or to donors.

In the case of wealthy nonprofit organizations, the interests of the elite workers become quite powerful. The idiosyncrasies of the particular CEO matter a lot, but the CEO will also end up making choices that are close to the choices that are preferred by the most entrenched workers. One reason for this connection is that CEOs are usually chosen from among the group of elite workers. Hospitals are often run by doctors, universities are often run by professors, and museums are run by curators. After all, running a nonprofit often requires specific skills that only the elite workers have. A second reason for the power of the workers is that they interact with the CEO and have the ability to make his or her life more or less pleasant.

As such, it should not surprise that over time, nonprofits, which were originally dominated by donors, ultimately resemble workers' cooperatives. Hospitals, museums, and universities have all transformed from institutions that maximized donors' interests to institutions that generally maximize the interests of their elite workers, making some exception for the continuing power of some boards and the idiosyncrasies of individual CEOs. To the extent that wages are free to adjust, the power of workers to push the nonprofits explains why there are lower wages in the nonprofit sector.

As much as I am convinced that there are serious governance issues within nonprofits, I also remain convinced that most nonprofits ultimately do a reasonable job of attending to their core function. The absence of powerful instruments of corporate control allows workers and managers a fair amount of latitude, but ultimately the sector still works. To some degree this may stem from the altruistic objectives of workers or managers, but in many cases, this probably comes from the need for nonprofits to compete in product markets and in the market for donations. Just as the model suggests, competition proves to be a powerful check on managerial whimsy. Ultimately, the lesson of nonprofits is that competition tends to keep organizations in line, even if their governance structure is weak. Perhaps this is ultimately the virtue of delegating social services to the nonprofit sector instead of having these services provided by the government.

Appendix

Proofs of Propositions

Proof of Proposition 1. In the nonprofit firm, production is set so that $K'(N) = P(|X - X_C|) + f'(N)/\lambda$. In the for-profit firm production is set so that $K'(N) = P(0)$. From the convexity of $K(.)$, the proposition immediately follows.

Proof of Proposition 2. First, we can immediately note that since $X_M > 0$, it is impossible for the optimal X to be negative. If X were negative, then an increase in X would please workers, donors, and the manager and there is (by assumption) no impact on price.

I will use the notation that $a = D + E - \underline{W}$, $b = d - \sigma B$, and $c = K - P$, so $N = (a - bx)/c$, and I denote the overall maximization problem of the manager as $V(X, a, b, c, C, g)$. The value of $(\partial V)/(\partial X)$ equals $g \cdot I(X < X_M) + C - f'([a - bx]/c)(b/c)$. Standard differentiation tells us that for any parameter Z, $(\partial X)/(\partial Z) = ([\partial^2 V]/[\partial XZ])/([\partial^2 V]/[\partial X^2])$ and the value of $(\partial^2 V)/(\partial X^2)$ equals $f''(N)([d - \sigma B]/[K - P])^2$ which is negative, so the sign of $(\partial X)/(\partial Z)$ is the same as the sign of $(\partial^2 V)/(\partial XZ)$.

The value of $(\partial^2 V)/(\partial X \partial C) = 1 > 0$ so X increases with C, and differentiation yields

$$\text{(A1)} \qquad \frac{\partial^2 V}{\partial X \partial D} = \frac{\partial^2 V}{\partial X \partial E} = -\frac{\partial^2 V}{\partial X \partial \underline{W}} = \frac{\partial^2 V}{\partial X \partial a} = -f''(N)\frac{b}{c^2} > 0,$$

and

$$\text{(A2)} \qquad \frac{\partial^2 V}{\partial X \partial b} = \frac{\partial^2 V}{\partial X \partial d} = -\frac{1}{B} \cdot \frac{\partial^2 V}{\partial X \partial \sigma}$$

$$= -\frac{1}{\sigma} \cdot \frac{\partial^2 V}{\partial X \partial B} = -\frac{f'(N)}{c} + f''(N)\frac{bX}{c^2} < 0$$

and

$$\text{(A3)} \qquad \frac{\partial^2 V}{\partial X \partial c} = \frac{\partial^2 V}{\partial X \partial K} = -\frac{\partial^2 V}{\partial X \partial P} = \frac{f'(N)b}{c^2} + f''(N)\left(\frac{bN}{c^2}\right),$$

which is certainly negative if and only if $f'(N) > -Nf''(N)$. Differentiation also yields.

Proof of Corollary 1. The proof of corollary 1 follows immediately from proposition 1, and the fact that wages equal $\underline{W} - \sigma BX$.

Proof of Proposition 3. We assume that $(\partial^2 V)/(\partial X^2)$ is negative and $(\partial^2 V)/(\partial X \partial g) = -I(X > X_M)$, which is negative if and only if X is greater than X_M, so the proposition holds.

Proof of Proposition 4. Adjusting the notation of the previous section, I now let $z = C + g$, $a = D + E - \underline{W}$, $b = d \cdot I(X > 0) - \sigma B$, and $c = K - P_0$, so $(\partial V)/(\partial X)$ equals $z - f'([a - bX]/[c + P_1 X])/([bc + aP_1]/[c + P_1 X]^2)$. Differentiating again produces $(\partial^2 V)/(\partial X^2) = ([bc + aP_1]/[c + P_1 X]^3)([\{bc + aP_1\}/\{c + P_1 X\}]f''[N] + 2P_1 f'[N])$, which is negative if and only if $-([bc + aP_1]/[c + P_1 X])f''(N) > 2P_1 f'(N)$, or $-(C + g)(K - P_0 + P_1 X)f''(N) > 2P_1 f(N)^2$, which we assume is negative, and so again, the sign of $(\partial X)/(\partial Z)$ is the same as the sign of $(\partial^2 V)/(\partial XZ)$. Differentiation gives us that

$$\text{(A4)} \qquad \frac{\partial^2 V}{\partial X \partial z} = \frac{\partial^2 V}{\partial X \partial g} = \frac{\partial^2 V}{\partial X \partial C} = 1 > 0,$$

and

$$\text{(A5)} \qquad \frac{\partial^2 V}{\partial X \partial D} = \frac{\partial^2 V}{\partial X \partial E} = -\frac{\partial^2 V}{\partial X \partial \underline{W}} = \frac{\partial^2 V}{\partial X \partial a}$$

$$= -f''(N)\frac{(bc + aP_1)}{(c + P_1 X)^3} - f'(N)\frac{P_1}{(c + P_1 X)^2},$$

and this is positive if $-f''(N)bc + aP_1/c + P_1 X > P_1 f'(N)$, which follows from the assumption that $-([bc + aP_1]/[c + P_1 X])f''(N) > 2P_1 f'(N)$. Further differentiation yields

$$\text{(A6)} \qquad \frac{\partial^2 V}{\partial X \partial b} = \frac{\partial^2 V}{\partial X \partial d} \cdot I(X > 0) = -\frac{1}{B} \cdot \frac{\partial^2 V}{\partial X \partial \sigma}$$

$$= -\frac{1}{\sigma} \cdot \frac{\partial^2 V}{\partial X \partial B} = f''(N)\frac{(bc + aP_1)X}{(c + P_1X)^3} - f'(N)\frac{c}{(c + P_1X)^2}.$$

This is negative as long as X is positive or close to zero. Further differentiation yields $z - f'([a - bX]/[c + P_1X])([bc + aP_1]/[c + P_1X])$.

$$\text{(A7)} \qquad \frac{\partial^2 V}{\partial X \partial c} = \frac{\partial^2 V}{\partial X \partial K} = -\frac{\partial^2 V}{\partial X \partial P_0}$$

$$= 2f''(N)\frac{(a - bX)(bc + aP_1)}{(c + P_1X)^4} + P_1 f'(N)\frac{a - bX}{(c + P_1X)^4},$$

which is negative if $-2f''(N)(bc + aP_1) > P_1 f'(N)$; and this follows from $-([bc + aP_1]/[c + P_1X])f''(N) > 2P_1 f'(N)$ as long as $4 > 1/(c + P_1X)$. Differentiation again yields

$$\text{(A8)} \qquad \frac{\partial^2 V}{\partial X \partial P_1} = f''(N)\frac{(a - bX)(bc + aP_1)X}{(c + P_1X)^4} - 2cf'(N)\frac{a - bX}{(c + P_1X)^4},$$

which is certainly negative.

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